VIRGINIA:

In the Supreme Court of Virginia held at the Supreme Court Building in the City of Richmond on Monday the 10th day of March, 1975.

Henry E. Howell, Jr., Appellant

against Record No. 740406

Chesapeake and Potomac Telephone Company of Virginia, et al., Appellees

Upon a Petition for Rehearing

On mature consideration of the petition of the appellant to set aside the decree entered herein on the 20th day of January, 1975, and grant a rehearing thereof, the prayer of the said petition is denied.

Mr. Justice Harrison did not participate in the consideration or decision on this petition for rehearing.

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OPINION BY JUSTICE A. CHRISTIAN COMPTON

Richmond, Virginia, January 20, 1975

FROM THE STATE CORPORATION COMMISSION

This is an appeal of right[1] by an individual intervenor from an order of the State Corporation Commission which authorized the Chesapeake and Potomac Telephone Company of Virginia to increase its rates for service rendered to Virginia telephone subscribers on and after January 22, 1974.

On June 15, 1972, C & P filed its application with the Commission for an increase in rates charged for its intrastate Virginia service. Prior to the present request, C & P had last obtained

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1/ Va. Const. art IX, §4; Code §12.1-39.

rate relief effective December 1, 1971. In the previous hearing, the Commission used a 1970 test period and prescribed rates designed to enable C & P to earn 8.5% on its intrastate investment. In the present case, C & P asserted that its capital requirements had continued to increase since 1971 and that because the overall cost of capital to it at the time of the instant application was at least 9.4%, it was necessary for it to achieve that return to attract the capital needed to provide adequate service to its Virginia customers. C & P's proposed rates and charges were designed to produce additional gross revenues of $36,048,000 and were set forth in an

exhibit attached to the application.[2]

The case matured and hearings commenced in September, 1972. After eight days of proceedings, the Commission granted a motion of its counsel to recess the case in order to give C & P an opportunity to gain a full year's experience under the increased rates authorized in the prior case. Hearings resumed in May, 1973, and concluded in the following month. The transcript of the eighteen days of hearings contains approximately 5,000 pages. More than

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2/ As the result of rulings made early in the hearings, C & P filed amended rate schedules and ultimately sought authority to publish revised tariffs which would produce $32,711,00 of additional gross revenues.

200 exhibits were introduced. During the proceedings, appearances were entered for seventeen parties including the Attorney General of Virginia,[3] the United States Department of Defense, and the appellant Henry E. Howell, Jr. (Intervenor), then Lieutenant Governor of Virginia, appearing pro se.

In the order appealed from entered on January 9, 1974, the Commission granted C & P a portion of the relief sought. Filed with the order was the majority opinion of Commissioner

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3/ Code §2.1-133.1 provides for the appearance of the Attorney General of Virginia before the Commission in hearings of this type to "represent the interests of the people as consumers."

Shannon with Commissioner Harwood concurring. Commissioner Bradshaw concurred with the majority except in those instances wherein the rate base determination conflicted with his views on the subject stated in a prior case.

The Commission, using 1972 as the test year, found that C & P level of earnings for that year was at the rate of 7.64% on a rate base of $808,477,597 as of December 31, 1972, and concluded that C & P was entitled to revenue relief. It found that C & P should be authorized to increase its schedules of rates and charges to enable it to earn an 8.65% rate of return upon the intrastate rate base. It further concluded that such rate of return upon

the rate base would give C & P an opportunity to earn an 11% return upon its equity capital. The Commission also determined that schedules of rates and charges designed to produce $12,636,371 in additional gross revenues would give C & P an opportunity to earn the 8.65% rate of return upon the rate base and accordingly denied C & P's proposal based on schedules of rates and charges intended to generate $32,711,000, note 2, supra, in additional gross revenues. The order also provided for distribution of the amount of the increase among various classes of customers.

We affirm the order of the Commission.

The Intervenor, who did not

present the testimony of any witnesses, but otherwise participated fully in the hearings, assigned sixteen errors. The basic issue is whether the Commission has acted within the scope of its legislative descretion. Specifically, the questions to be decided are whether the Commission erred in finding that a fair rate of return for C & P on its intrastate rate base was 8.65%; whether the Commission's method of determining intrastate rate base was proper; and whether the Commission erred in allowing certain charitable contributions to be deducted as expenses when determining net income.[4/]

4/ The Commission, an appellee, through its counsel filed a separate brief stating that it is "in the nature of an offering of an amicus curiae. The primary argument has been left to the Company which received the benefit of

C & P, a Virginia corporation and a wholly-owned subsidiary of American Telephone and Telegraph, furnishes telephone communication service within the State of Virginia. The Commission's majority opinion notes that "AT&T also owns all, or part, of the capital stock of various other telephone companies operating throughout the United States and Canada. All of these companies together are known as the Bell System, which also includes Western Electric

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4/ (Continued)

the rate increase approved by the Commissions order. The Commission's response to Howell's brief is offered to demonstrate to this Court that its order, on appeal in this proceeding, fully conforms with the prior decisions of this Court, complies with sound principles of utility regulation, and reasonably lies within the bounds of legislative discretion conferred by the Constitution of Virginia and the General Assembly of Virginia."

Company and Bell Telephone Laboratories, Inc. Each operating company, including C & P of Virginia, manages and conducts its internal affairs to the extent that the parent, AT&T, and the local company deem it economically and practically expedient to do so." C & P's Virginia rates, charges, services and facilities are subject to the regulatory power of the State Corporation Commission.[5/]

C & P's evidence showed that following the 1971 rate increase, it earned the then authorized return of 8.5% on its average rate base for approximately one year, and that during the latter part of 1972, its earnings

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5/ Va. Const. art. IX, §2; Code § 12.1-12.

began to fall to a point where the adjusted earnings for 1972 were only 7.29%. Citing the growth in its construction program from 1971 to 1973, C & P's evidence also showed the necessity of earning 9.33% on its Virginia jurisdictional properties which would afford the opportunity for a return of 12.5% on its common equity. C & P contended, as stated, that $32,711,000 of additional gross revenue was required to attain the foregoing level of earnings.

Before the Commission, opposition to the proposed increase came from both residential and business customers of C & P. The contentions of the opponents were many and varied. For example,

the Department of Defense contended that no rate increase was necessary because no justification had been shown for a rate of return higher than 8.5%, which, it asserted, C & P was then earning. Arlington County contended that C & P was entitled to a 10.75% return on common equity using a 50% debt equity ratio. It urged that additional gross revenues be limited to $4,682,000. The Attorney General of Virginia took the position that the 8.5% rate of return was sufficient and, when applied to a 1972 rate base of approximately $752,000,000 (as computed by another intervenor), would justify an increase of C & P's gross revenues of not more than $10,000,000.

The Commission's staff made a thorough examination and study of C & P's

books and records. It analyzed C & P's proposed rate structure, rules and regulations. It employed an economist who testified concerning rate of return and cost of capital. The staff recommended an overall rate of return ranging from 8.29% to 8.68% which would produce a return on equity of 10.2% to 10.7%. This was based on a capital structure consisting of 50% to 55% debt, with the balance in equity and deferred taxes.

The Commission's majority opinion carefully examined the evidence and discussed in detail the test period, the rate base, the rate of return, and the rate design. It pointed out that the 1972 calendar year test period was reasonable because when hearings on the application commenced in September, 1972,

C & P did not have a complete year's earning experience under the increase granted in the 1971 rate case, and to proceed at that time with the hearings would have required the use of projections to arrive at a full twelve month test period. Consequently, the case was recessed and C & P's actual 1972 experience was available as evidence when the hearings resumed.

The Commission defined C & P's rate base as including ". . . the total investment in its plant and equipment used and useful in intrastate public service plus an allowance for working capital, which is the investment in cash, materials, supplies, etc., necessary for the efficient and economical day-to-day operations of the Company." It found

that as of December 31, 1972,". . . the original cost of utility plant used and useful both in interstate and intrastate commerce plus allowances less reserves was $1,046,675,939." It used "separation procedures" established in a Separation Manual, as amended, used by the National Association of Regulatory Utility Commissioners - Federal Communications and adopted for use by the FCC, to allocate and separate C & P's plant and expenses into intrastate and interstate components.[6/] C & P made the actual separations study, and it was verified by the Commission's staff,

6/ These items must be divided between interstate and intrastate uses for rate making purposes because C & P's interstate and Virginia intrastate operations are regulated by the Federal Communications Commission and the State Corporation Commission respectively.

which found the December 31, 1972, intrastate rate base to be $805,860,133. The Commission adopted that finding but adjusted it because, subsequent to the conclusion of the hearings, new depreciation rates prescribed by the FCC were published, thereby causing a reduction in C & P's Virginia depreciation expense by $2,617,464 in 1972, and thereby increasing the intrastate rate base to $808,477,597. This determination was reflected in the following table in the majority opinion:

"Virginia Intrastate Rate Base
as of December 31, 1972

Telephone Plant at December 31, 1972	
Telephone Plant in Service	$ 963,773,952
Telephone Plant Under Construction	37,792,000
Property Held for Future Telephone Use	690,933
Total Telephone Plant	$1,002,256,885

Less: Depreciation Reserve		$ 206,029,063
Net Telephone Plant		$ 796,227,822
Allowance for Working Capital		
Materials and Supplies	$ 4,418,387	
Cash (Approximately 20 Days of Operating Expenses, Exclusive of Depreciation and Amortization)	7,831,388	
Total Allowance for Working Capital		$ 12,249,775
Net Utility Plant and Allowances		$ 808,477,597"

Using the Separations Manual, the Commission found that of the total operating revenues of $412,463,747, C&P's Virginia intrastate revenues $309,358,630, after certain adjustments were made. It further found that of the total operating revenue deductions of $334,685,381, C&P's Virginia adjusted intrastate operating revenue deductions were $250,507,906. Intrastate net income was reduced to reflect net

charitable contributions of $101,409.

The below table from the Commission's opinion shows the test period level of earnings.

"Level of Earnings Under Existing Rates - 1972

Total Operating Revenues		$309,358,630
Total Operating Revenue Deductions	$251,570,835	
Plus: Cost of Living-Wage Adjustment Net	298,152	
Less: Net Depreciation Revision	1,361,081	250,507,906
Net Operating Income		58,850,724
Plus: Interest During Construction		3,045,347
Less: Charitable Contributions (Net)		101,409
Net Operating Income Adjusted (Current Level of Earnings)		$ 61,794,662"

This demonstrated that on the rate base of $808,477,597, the level of earnings was at a rate of 7.64%.

The rate of return issue generated considerable disagreement among the parties. The "cost-of-money" expert witnesses urged overall rates of return from 7.9% (Department of Defense) to 9.33% (C & P) and return on equity from 9.3% (Department of Defense) to 12.5% (C & P). The capital structure to be used in determining a fair return for C & P was also a controversial subject. The Commission concluded that it was proper to use the debt ratio of the Bell System, of which C & P is a part, in computing C & P's cost of capital. City of Lynchburg v. Telephone Company, 200 Va. 706, 107 S.E.2d 462 (1959).[7/]

7/ For an explanation of the importance of the debt and equity ratio in fixing the rate of return, see 200 Va. at 718-19, 107 S.E. 2d at 470-72.

The Commission stated that ". . . the evidence in this case does not justify departure from use of the Bell System's capital ratio and we will, therefore, use AT&T's consolidated objective capital structure of 45 percent debt, 4 percent preferred and 51 percent equity, which capital structure insofar as C & P is concerned is hypothetical. We feel that use of AT&T's consolidated objective capital structure for rate-making purposes is fair to both the subscribers and the Company." Using the foregoing hypothetical capital structure, the Commission concluded that 8.65% was a just and reasonable overall rate of return and that this would afford C & P an opportunity to earn a return on equity of approximately 11%. The Com-

mission determined that a 45% debt ratio would increase interest expense, thereby resulting in a reduction of $1,862,215 in C & P's Federal income tax. Net operating income would increase in the same amount. Accordingly, the foregoing net operating income for 1972 of $61,794, 662, adjusted for the effect of the assumed capital structure, would increase to $63,656,877. This was illustrated in the Commission's opinion as follows:

"Level of Earnings Under Existing Rates - 1972

Total Operating Revenues	$309,358,630
Total Operating Revenue Deductions	$251,570,835
Plus: Cost of Living Wage Adjustment	298,152

Less: Net Depreciation Revision	1,361,081	
Less: Reduction in Federal Income Tax as result of Hypothetical Debt Ratio	1,862,215	248,645,691
Net Operating Income		$ 60,712,939
Plus: Interest During Construction		3,045,347
Less: Charitable Contributions (Net)		101,409
Net Operating Income Adjusted		$ 63,656,877"

The Commission then concluded that C & P required $12,636,371 in additional gross revenues. As demonstrted by its table below, it applied the allowed rate of return to the adjusted rate base and determined C & P's earnings requirements. Then, by deducting adjusted net operating income as set forth in the above table, the additional earnings required were computed as follows:

"December 31, 1972 Rate Base	$808,477,597
Percentage Rate of Return	8.65
Total Net Earnings Needed	$ 69,933,312
Net Earnings- Test Period (After Adjustments)	63,656,877
Additional Net Earnings Needed	$ 6,276,435
Additional Gross Earnings Needed	12,636,371"

Finally, in its opinion, as stated, the Commission discussed the rate design, that is, the manner of distribution of the authorized increase among C & P's classes of customers.

There are fundamental and established criteria for judicial review of an order of the Commission fixing rates and charges for a public utility. In the discharge of its constitutional mandate, the Commission is empowered to fix rates which "shall be just and rea-

sonable." Code § 56-235. This is a purely legislative function and, in such matters, the Commission is the legislative branch of the government. Norfolk v. Chesapeake, etc., Tel. Co., 192 Va. 292, 300, 64 S.E.2d 772, 776 (1951). "In fixing rates within the limits of what is confiscatory to the utility on the one side, and exorbitant as against the public on the other side, and thus definitely unfair and unjust to the telephone users, there is a reasonably wide area within which the Commission is empowered to exercise its legislative discretion. As it enjoys the full legislative power of the State within these bounds, the rate of return that it allows may not be changed or set aside as confiscatory or unreasonable and

unjust unless it clearly evinces an abuse of legislative discretion." Id. In fixing rate of return, the Commission functions as an expert tribunal and its order, upon review, is presumed to be just, reasonable and correct. Commonwealth v. Portsmouth Gas Co., 213 Va. 239, 241, 191 S.E.2d 220, 222 (1972). "We do not sit as a board of revision to substitute our judgment for that of the legislature, or of the Commission lawfully constituted by it, as to matters within the province of either." Chesapeake, etc., Tel. Co. v. Commonwealth, 147 Va. 43, 57, 136 S.E. 575, 578 (1927) quoting from the Minnesota Rate Cases, 230 U.S. 352, 433 (1912).

Controlled by the foregoing settled principles, we examine the con-

tentions of the Intervenor. Initially, in order to evaluate properly the issues raised in this case, the basic elements of rate making should be reviewed. In a rate case, the Commission must first ascertain the value of the applicant's property used and useful in the rendition of its intrastate service (rate base), its annual gross revenues, and its annual operating expenses. Norfolk v. Chesapeake, etc. Tel. Co., supra, 192 Va. at 301, 64 S.E. 2d at 777. When these matters have been determined, the Commission must set the "percentage rate of return at such a figure as will afford the utility reasonable opportunity to earn a fair and just return on its investment." 192 Va. at 301-02, 64 S.E.2d at 777-78. See 1 A.J.G. Priest,

Principles of Public Utility Regulation 45 (1969).

First, the Intervenor contends that improper rate of return evidence was used as the basis for finding the 8.65% rate. He argues that the settled law "(p)recluded the Commission from finding a fair return for the Virginia intrastate jurisdiction based upon financial data and rate of return testimony which did not solely relate to the Applicant's cost of serving the Virginia intrastate jurisdiction." The Intervenor apparently takes the position that in determining rate of return, the Commission is restricted to economic factors existing wholly within the State of Virginia when considering cost of money. We reject this contention. Following

established rate making procedures, the Commission examined intrastate rate base, intrastate revenues and intrastate expenses. Then it determined a fair rate of return for C & P's intrastate business by considering evidence showing the Bell System's nationwide experience. C & P was properly treated as a "miniature Bell System." City of Lynchburg v. Telephone Company, supra, 200 Va. at 718, 107 S.E. 2d at 471.

The Commission's approach follows the principle that the return to the equity owner should correspond with returns on investments in other businesses having corresponding risks, and the return "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to

maintain its credit and to attract capital." Federal Power Commission v. Hope Natural Gas, 320 U.S. 591, 603 (1944). Accordingly, in this case consideration of merely local, and even regional, rate of return evidence would have been inappropriate. When establishing a figure which "will afford the utility reasonable opportunity to earn a fair and just return on its investment," a nationwide perspective is necessary and was appropriate in this case.

The Intervenor next contends that customer deposits, unamortized investment tax credit reserves, the reserve for deferred taxes, and unmatured interest were improperly included by the Commission in the rate base.[8/] He relies upon

8/ Commissioner Bradshaw excepted to the inclusion of customer deposits in rate base.

Princess Anne Utilities Corporation v. Commonwealth, 211 Va. 620, 179 S.E.2d 714 (1971) and contends that the inclusion of the foregoing accounting items in rate base required "customers to pay a rate of return on property which has been purchased with their own funds." We disagree. In Princess Anne, we decided that the Commission properly excluded contributions in aid of utility construction in determining the utility's rate base. 211 Va. at 623, 179 S.E.2d at 716. None of the foregoing accounting items are "contributions in aid of construction" nor may a proper analogy be drawn in this case between the contested items and the item considered in Princess Anne. The Commission established an end-of-period net original cost investment rate

base in this case and the inclusion therein of the foregoing entries properly falls within the range of its legislative discretion.

Finally, the Intervenor argues that the Commission erred in allowing deduction of net charitable contributions of $101,409 when net income was determined. This contention is without merit. The allowance of this item has been previously approved by us and we adhere to that view in this case. Board of Supervisors v. VEPCO, 196 Va. 1102, 118, 87 S.E.2d 139, 149 (1955).

From a review of this entire record, we hold that the Intervenor has failed to show an abuse of legislative discretion and the order of the Commission will, therefore, be affirmed.

Upon motion of the appellee, the cost of producing the appendix, including the costs advanced by the appellee as required by Rule 5:36(b), shall be taxed to the appellant. Code § § 14.1-181 and 14.1-182.

Affirmed.

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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

Application of CASE NO. 19152

THE CHESAPEAKE AND POTOMAC
TELEPHONE COMPANY OF VIRGINIA

January 9,1974

For an increase in rates.

Opinion, SHANNON, Commissioner:

On June 15, 1972, The Chesapeake and Potomac Telephone Company of Virginia, hereinafter sometimes referred to as "C&P" and "Company," filed with the Commission an application and tariff schedules designed to produce an increase in gross annual revenue of approximately $36,600,000. Hearings commenced on September 18, 1972, and continued for eight days, at which time the Commission granted a motion of its

counsel to recess the case until the last full three weeks in April, 1973, in order to afford the Company an opportunity to gain a full year's experience under the increased rates authorized by this Commission in its Order in Case No. 18965, which became effective on December 1, 1971. Subsequently, a pretrial conference was held on April 18, 1973, for the purpose of working out the procedural aspects in the continued case. Following this conference, hearings were resumed on May 15, 1973, and continued intermittently for ten days ending on June 29, 1973.

During the 1972 hearings, the Commission ruled that it would not consider an attrition allowance since it

would use a year-end rate base and that no increases for public coin-operated telephone service would be allowed. Accordingly, during the hearings the Company filed amended rate schedules designed to produce various amounts.[1] On brief, C&P seeks authority to publish revised tariffs which would produce $32,711,000 in gross revenues.

The following appearances were entered during the eighteen days of proceedings in 1972 and 1973; Joseph E. Blackburn, Robert A. Levetown, Warner F. Brundage, Jr., Alfred Winchell Whittaker, for C&P; Andrew P. Miller,

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[1]The Company's rate testimony submitted during the hearings indicated that the proposed rates would produce increased revenues in varied amounts of $36 million, $38 million, $24 million, and $31 million.

Attorney General, Commonwealth of Virginia; Henry M. Massie, Jr., Assistant Attorney General; Henry E. Howell, Jr., Lieutenant Governor of Virginia, Individual Intervener; Clive L. DuVal, 2d, Individual Intervener; John T. Schell, Counsel for Senator DuVal; Jerry K. Emrich, for Arlington County; H. Bailey Lynn, for Fairfax County; Dellon E. Coker, for the Department of Defense; A. C. Epps and Charles Midkiff, for the Virginia Committee for Fair Utility Rates; William R. Durland, for the Virginia Citizens Consumer Council and Orange Hunt Estates Civic Association; Leonard A. Paris, for Chesterfield County; Raymond R. Robrecht, for Electralarm Systems, Inc.; Andrew J. Ellis,

Jr., and Kenneth V. Farino, for Hanover County; Leslie V. Dix and John F. Kelly, for Telephone Answering Services Committee for Reasonable Rates; W. Stephen Moore, for Multra-Guard, Inc.; Marvin F. Cole and Edwin B. Spievack for Jarvis Company, Inc.; and Richard D. Rogers,Jr. for the Commission.

During the course of the hearings, twenty-four public witnesses appeared. Much of the testimony of these witnesses related to service problems and the desire for county-wide extended area service. Since this Commission has under study the Extended Area Service (EAS) question, and since service complaints are handled on an individual basis, most of the questions raised by the twenty-four public witnesses are being

dealt with separately, and the Commission will confine itself in this Opinion to those issues essential to a proper determination of the rate case.

Preliminarily, there are several motions which must be considered. Motions to dismiss were filed by Clive L. DuVal, 2d, and Henry E. Howell, Jr. Both motions are predicated upon the contention that C&P has not offered sufficient evidence to support its claim that current earnings do not constitute a fair return on its investment on its Virginia intra-state jurisdictional rate base. Upon carefully considering the evidence of record, we hereby deny these motions.

Governor Howell also filed a motion for an order for the Commission

to furnish him with a free copy of the transcript of proceedings. In a prior proceeding involving an application by Virginia Electric and Power Company for an increase in rates, Governor Howell made a similar motion, i.e., that either VEPCO or the Commission furnish him a free transcript of evidence for use in appealing the decision of the Commission. That motion was denied by the Commission, which action was affirmed by the Virginia Supreme Court on appeal. See Henry E. Howell, Jr. v. State Corporation Commission and Virginia Electric and Power Company, 214 Va. 128 (1973). While Governor Howell's present motion does not portray any given purpose the transcript is intended to serve, we consider this to be a distinction with-

out a difference. In the above-cited case, the Supreme Court unqualifiedly determined that nothing in the Constitutions of the United States and Virginia, or in Virginia statutes, requires "...the Commission to furnish the appellant (Howell) with a free transcript of the evidence, ..." Id. at 129. We consider this recent pronouncement to be dispositive, and the motion for a free transcript is, therefore, denied.

POSITION OF PARTIES

As is evident from the list of appearances in this proceeding, opposition to the proposed rate increases emanated from both residential and business customers of C & P. The positions taken by the parties are varied.

The Company points to the fact that in the last rate proceeding Chesapeake and Potomac Telephone Company of Virginia, 91 PUR 3d 437, decided November 17, 1971, the Commission found that 8.5% was a fair rate of return on a net original cost, end-of-period rate base adjusted for out-of-period wage increases. But the Company maintains it earned the authorized return only on its average rate base for the year following this Commission's 1971 Order, and that commencing in late 1972 C & P's earnings dropped below the authorized rate of return and continued downward to the point where the Company's adjusted earnings for 1972 were only 7.29%. Accordingly, the Company asserts

that the principal issue in this proceeding is whether C & P will be allowed a reasonable opportunity to earn a fair return under the economic conditions which now prevail, and, consequently, continue providing quality telephone service to Virginia citizens. Anything less than a fair rate of return, C & P says, would redound to the detriment of both the customers it serves and the Company alike.

According to C & P's witnesses, the Company is highly capital intensive and in order to maintain an adequate level of quality service, its construction program has grown from under $144,000,000 in 1971 to about $200,000,000 in 1973. Since over half

of the Company's new capital requirements must be secured from investors, it will be necessary for the Company to be afforded an opportunity to earn 9.33% on its Virginia jurisdictional properties, which, if earned, would produce for C & P a return of 12.5% on its common equity, using the Bell System objective consolidated capital structure.[2] To achieve this level of earnings, according to the Company's testimony, will require increased gross

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[2]Dr. Walter A. Morton, a former Professor of Economics of the University of Wisconsin, testified that a fair rate of return to C&P on property subject to the jurisdiction of the Virginia Commission would be 9.33%. Mr. William G. Burns, Assistant Treasurer of AT&T, recommended a 9.25% rate of return for C&P, which was arrived at by using a 12.5% return on common equity and employing the Bell System objective capital structure, including deferred taxes at zero cost.

revenues of $32,711,000.

In his brief, the Attorney General contends that the Company is presently authorized to earn an 8.5% rate of return and that nothing in the instant case necessitates increasing this rate of return, which when applied to the Company's average rate base for 1972 of $752,013,000 as computed by one of the interveners would justify an increase of not more than $10,000,000 in the Company's gross revenues.

Although the Lieutenant Governor of Virginia did not present the testimony of any witnesses in his behalf, he did, however, cross-examine most of the Company's witnesses at length, and filed two voluminous briefs. The Lieutenant Governor attacks the rate base/rate of

return method of rate making followed by this Commission for many years with the approval of the Virginia Supreme Court. He alleges that "The present rate base/rate of return method is not only internally inconsistent in that the rate of return formula does not match the rate base, it also violates the legal standard of jurisdictional integrity which requires that a commission set rates for its jurisdiction with exclusive reference to the utility's cost of serving the jurisdiction." Also, the Lieutenant Governor contends that the Virginia Supreme Court's decision in Princess Anne Utilities Corporation v. Commonwealth of Virginia, 211 Va. 620, requires a determination of exactly how much of the property used in fur-

nishing jurisdictional service was purchased with funds supplied by customers through their rates on which property the Commission should not allow any return. The impact of the Princess Anne Case, according to the Lieutenant Governor, "... is sure to have a great effect on the financial reporting procedures followed by the SCC, and on any method of rate making it may choose to adopt in the future." Additionally, the Lieutenant Governor contends that the Company should not be permitted to include in its operating expenses charitable contributions. These, he says, should be charged to the Company's stockholders and not to the ratepayer. The record is not clear concerning the

dollar amount of increase, if any, to which the Lieutenant Governor feels C&P is entitled; however, in his pre-hearing brief, he asks the Commission to "act immediately to reduce the allowed rate of return of the 'Company' to conform to the return allowed on other investments of similar risks in this locality."

The Virginia Committee for Fair Utility Rates[3] contends that C&P is seeking an unreasonable and unrealistic return on its investment which will require business interests to bear an

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[3]The Virginia Committee for Fair Utility Rates represents Newport News Shipbuilding and Dry Dock Company, Allied Chemical Corporation, Continental Can Company, American Oil Company, Reynolds Metals Company, and I.C.I. of America, Inc.

inequitable share of any increase. Through its witness, Dr. Herschel F. Jones, the Committee recommends use of a hypothetical capital structure for C&P, consisting of 45% long-term debt; 4.74% advances from AT&T; 47.59% common equity; and, 2.67% deferred taxes at zero cost.

The Committee, through certain adjustments, restates the Company's test-year net earnings at $67,277,492, which applied to the Committee's year-end adjusted rate base of $803,340,000, produces an 8.38% rate of return for the test year, which return the Committee asserts is sufficient. Next, the Committee would reduce test-year net income of $64,635,000 by $815,000 to

reflect annualized 1972 wage adjustments and certain minor items. With this adjusted test-period income of $63,820,000 it contends that C&P earned 7.94% on its 1972 end-of-period rate base of $803,340,000. Thus, without a rate increase, C&P's projected rate of return on 1973 year-end rate base would be 7.42% of a .52% erosion of earnings under 1972. Adding this .52% erosion factor to the Committee's proposed overall 8.3% rate of return produces a rate of 8.82%. Applying this to its adjusted 1972 year-end rate base of $803,340,000 (which is the staff's determination of rate base less customer deposits), the Committee concludes that total net earnings of $7,855,000 are needed prior to giving the ratepayer

the tax benefits associated with a reasonable debt-equity ratio. Using Dr. Jones's 49.74% of debt, which would produce a $3,072,000 tax savings, the Committee concludes that the total net earnings required by C&P would amount to $67,783,000. Since adjusted test-year revenues amounted to $63,820,000, the net income deficiency for the projected year is $3,963,000, reflecting a need for additional gross income of $7,926,000.

Senator DuVal contends that a rate of return of 8.3% is well within the zone or reasonableness for C&P; that no additional earnings are required in light of the increased net earnings for 1973 over 1972 and the increase in 1973

net earnings due to decreases in depreciation. But should the Commission find that an increase in rates is warranted, Intervener DuVal urges that the rate of return allowed be computed without consideration for out-of-period adjustments and by using an average rate base.

The Department of Defense and other executive agencies of the United States assert that C&P has not justified a rate of return higher than 8.5% and since the Company is now earning at that level, no rate increase is justified.

Arlington County maintains that C&P is entitled to a 10.75% return on common equity employing 50% hypotheti-

cal debt ratio. Based on its restatement of the Company's "lag study," Arlington County would reduce net requirements for cash working capital to $245,086 and reduce the amount allowed for material and supplies by $544,770. Arlington recommends that C&P be allowed additional gross revenues of $4,682,000.

Fairfax County's basic position is that if an increase in rates is allowed, it should be placed on what it characterizes as luxury or nonessential items, such as extension phones, Touch-Tone, Princess, Trimline, color phones, and other services that go beyond the basic black rotary dial telephone.

The Telephone Answering Services Committee (TASC), representing the pri-

vate nonregulated answering services, opposes the increases set out in C&P's proposed tariffs for services to its members. Telephone Answering Services is a small but important adjunct to overall telephone service. Briefly, as we understand the Committee members' operations, in the days of the manual switchboard, C&P performed many of the services that Telephone Answering Services now performs. Today, however, TASC's members, for a fee, provide the services of answering, referral and delivery of messages through their own operators on lines connected to C&P subscriber circuits. TASC operators use a 557B Board, some of which have been in service for many years. In

1971, the rates of TASC's members were increased 50% from $40 to $60. Another 33 1/3% increase from $60 to $80 is proposed in the tariff charges now under consideration, thus making this class of customer subject to a 100% increase for the 557B Board over a two-year period. The TAS Committee objects to the increases proposed in three respects:

(1) That the rate level proposed for the 557B Board and mileage charges for answering connections are excessive.

(2) That the monthly rates for concentrator-identifier equipment[4] should be allocated between the telephone answer-

[4]The concentrator identifier is an electro-mechanical device which allows calls to the answering board to be carried on a fraction of the total circuits intercepted with proper identification of the originating circuit.

ing bureau and the patron. (3) TASC should not be subject to the same service-connection charges which C&P charges its regular general service customers. In this latter connection, TASC asserts that its subscribers are bulk users of a specialized connection, and, consequently, such service is not the same as the services required by the Company's normal general service subscriber.

Another intervener, Jarvis Company, Inc., is engaged in the business of selling and/or leasing to telephone subscribers interconnection devices, i.e., telephone sets and all related equipment which is inter-connected with the Company's lines. The interconnection industry came into being in

consequence of the Federal Communications Commission's decision in Use of Carterfone in Message Toll Telephone Service, 77 PUR 3d 417, decided on June 26, 1968. Insofar as state regulatory bodies are concerned, the matter is still in litigation. Like telephone answering service companies, interconnect companies are not regulated. This Commission allows tariff filings for interconnection service, but has made no formal ruling on the status of interconnect companies. Jarvis contends that as a result of its available services, competition has been added as a factor in telephone rate making. This intervener opposes a proposed reduction of $928.814 in the Company's rates, which, Jarvis says, would jeopardize

its competitive position in selling its services. Jarvis further contends that any increase approved should be uniformly applied to all users and that the rates for PBX systems should be increased by 25%. Finally, it maintains that the CDC Coupler - which is used exclusively by interconnect customers - should be excepted from any increase authorized in this proceeding.

The Commission's staff, through its Acting Chief Accountant, Mr. E. M. Vassar, made a detailed study of C&P's books and records, and its Chief Engineer has analyzed the rate structure, rules and regulations proposed by the Company in this proceeding. The staff engaged an economist, who submitted

testimony concerning the rate of return and cost of capital. Through this witness, the staff recommended an overall rate of return in the range of 8.29% to 8.68% which would produce a return on equity in the range of 10.2% to 10.7%, based on a capital structure consisting of 50% to 55% debt, with the balance in equity and deferred taxes.

Mr. Frank Givens, the Commission's Chief Engineer, presented testimony concerning the rate structure proposed for both exchange and toll service and on the status of depreciation. He opposed the further increase in the station connection charges on the grounds that a large part of the cost is capitalized and recovered through depreciation expense.

Mr. Givens indicates approval of the proposal to make intrastate toll rates more comparable with interstate toll rates. Objection was made by this witness to the amount of increase in operator-handled calls.

Mr. Givens testified to the effect that the upgrading of rural telephone service ordered within a two-year period in our Order of November 17, 1971, was anticipated to be completed in 1973, which would produce at least $230,000 additional revenue in 1973 from these subscribers. Also, he stated that study of automatic regrouping of exchanges near the top of existing rate groups indicated there would be about $617,120 in additional revenues in 1973 from the increased charges when re-

grouped.

Importantly, Mr. Givens stated that determination of depreciation rates for C&P was under study in conjunction with the Federal Communications Commission. Agreements were not reached prior to the end of the hearing, but it was anticipated that depreciation expense would be reduced.[5]

Finally, the Commission's Accounting Division, after making certain ad-

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[5]By Order dated December 5, 1973, the Federal Communications Commission approved modification of percentage of depreciation rates for the C&P of Va., effective retroactively to January 1, 1973. The proposed decrease in annual depreciation expenses in both interstate and intrastate operations amounts to approximately $3,652,000 for C&P of Va., on the basis of C&P's annualized January 1, 1973, depreciable property.

justments to the Company's rate base and expenses during the test period, demonstrates that the proposed rates would produce a 9.47% rate of return.

Before determining the value of C&P's Virginia intrastate rate base and the reasonableness of the test year employed in this proceeding, it is appropriate to state that The Chesapeake & Potomac Telephone Company of Virginia is a wholly-owned subsidiary of the American Telephone & Telegraph Company (AT&T). AT&T also owns all, or part, of the capital stock of various other telephone companies operating throughout the United States and Canada. All of these companies together are known as the Bell System, which also includes

Western Electric Company and Bell Telephone Laboratories, Inc. Each operating company, including C&P of Virginia, manages and conducts its internal affairs to the extent that the parent, AT&T, and the local company deem it economically and practically expedient to do so.

TEST PERIOD

As previously indicated, C&P filed its initial application and schedule of rates and charges for telephone service in Virginia on June 15, 1972. The case came on for hearing on September 18, 1972, and, consequently, C&P had available as a test period, ending August 31, 1972, just eight months of earnings under the rate increases approved by this Commission in the 1971

rate case. This would have necessitated using projections to arrive at a full twelve-months' test period. Instead of permitting this procedure to be followed the Commission continued the case, there by requiring the Company to submit data for a twelve-months' period ending December 31, 1972, which would be the test year to be used in this proceeding. Accordingly, accounting testimony was adduced showing the net utility plant investment base and earnings for the calendar year 1972. Adjustments to the book figures have been made to develop as fairly and accurately as possible pro forma earnings and investment applicable to C&P's Virginia intrastate operations. Accordingly, we find that the 1972 calendar year test period is rea-

sonable and supported by the evidence. It is now in order to consider the testimony concerning the proper rate base to be used by the Commission.

RATE BASE

For the purpose of this proceeding, C&P's rate base includes the total investment in its plant and equipment used and useful in intrastate public service plus an allowance for working capital, which is the investment in cash, materials, supplies, etc., necessary for the efficient and economical day-to-day operations of the Company.

Section 56-234 of the Code of Virginia, as amended, provides:

> "Duty to furnish adequate serice at reasonable and uniform rates. -- It shall be the duty of every public utility to furnish reason-

ably adequate service and facilities at reasonable and just rates to any person, firm or corporation along its lines desiring same, and to charge uniformly therefor all persons or corporations using such service under like conditions. The charge for such service shall be at the lowest rate applicable for such service in accordance with schedules filed with the Commission pursuant to § 56-236." (emphasis supplied)

The economic tests of a fair rate of return to a public utility were stated by the United States Supreme Court in its 1944 decision in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 603:

"From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. (Footnotes omitted) By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding

risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

Prior to the Hope Case, supra, the Supreme Court of Appeals of Virginia stated similar criteria in its 1922 decision in Petersburg Gas Company v. Petersburg, 132 Va. 82, on page 102:

"The real test of the justice and reasonableness of any rate seems to be that it should be as low as possible, and yet sufficient to induce the investment of capital in the business and its continuance therein."

As this Commission has observed many times, most recently in Application of Virginia Electric and Power Company, Case No. 19027, 95 PUR 3d 281 on page 288:

"Both the decisions of this commission and the supreme court

> of Virginia recognized that a fair rate of return is a percentage figure which, when applied to the rate base, produces in dollars the actual earnings requirement of the company. ... Notwithstanding the concomitant complications of the rate base/rate of return method, its use in Virginia has long-standing approval of both this commission and the supreme court of Virginia, the most recent approval being set out in the supreme court of appeals' 1971 decision in Virginia v. Virginia Electric & Power Co., supra."

Based on C&P's records as of December 31, 1972, the original cost of utility plant used and useful both in interstate and intrastate commerce plus allowances less reserves was $1,046,675,939. C&P's interstate operations are regulated by the Federal Communications Commission and this Commission regulates intrastate message toll and local exchange service. Under this division

of regulatory responsibility, since the bulk of the Company's plant and expenses are used in furnishing both interstate and intrastate communications' service, such plant and expenses must be allocated or separated, between interstate and intrastate uses for purposes of rate making by the Federal and State Commissions. The procedures used in dividing the joint costs of plant and expenses are commonly referred to as "separations procedures," and are set forth in a Separations Manual issued by the National Association of Regulatory Utility Commissioners (NARUC)-Federal Communications Commission (FCC) Committee on Communications and prescribed for use by the FCC. The

procedures employed to separate intrastate from total Company operations for the calendar year 1972 are based on a revised Separations Manual issued in February, 1971, known as the "Ozark Plan" which incorporated Amendments made in 1964, 1965, and 1969 to the 1963 Separations Manual. The 1971 Amendment represents the revisions recommended by the FCC-NARUC Joint Board which were adopted by the FCC in Docket 18886 on October 27, 1970; such revised procedures for jurisdictional operations became effective January 1, 1971, with no other changes through the test period.

The actual separations study was made by the Company and checked for

accuracy by the staff. As a result of this study the staff has developed an intrastate rate base of $805,860,133 as of December 31, 1972. None of the interveners takes exception to applying the separations procedures to the total rate base to obtain the Virginia intrastate rate base.

The Attorney General does not take exception to the use of the end-of-period jurisdictional rate base. He does, however, suggest a reduced rate base of $797,000,000, over $8,500,000 less than that shown by the staff. He accomplishes this by eliminating approximately $2,000,000 of customer deposits and by using a modified version of the lag study introduced by Arlington County which reduces the amount the

staff allowed for working capital by slightly more than $6,500,000.

Arlington County Board reduces net requirements for cash working capital to $245,086 and would reduce Materials and Supplies by $544,770 based on a "lag study" it submitted.

The Virginia Committee for Fair Utility Rates urged that an average rate base must be adopted. The Committee further contended that $2,500,000 in customer deposits should be deducted from the rate base.

The Department of Defense (DOD) advocated that the Commission subtract accelerated depreciation and investment credit reserves which are applicable to the Virginia intrastate operations of C&P from its rate base. DOD main-

tains that this treatment is better than inclusion of these amounts in the capital structure at zero cost since the capitalization used in determining the rate of return for the Company is that of AT&T rather than C&P of Virginia. Also, the Department of Defense takes exception to use of the end-of-period rate base, and would deduct deferred taxes from the rate base.

Fairfax County Consumer Protection and Public Utilities Commission also advocates adoption of an average rate base.

Similarly, Senator DuVal opposes use of the year-end rate base.

Governor Howell contended that customer deposits as well as unamortized investment tax credits should be de-

ducted from the rate base. He also contends that the average rate base must be used.

Much of the discussion in this case concerns the question of what is a proper rate base on which the Company should be allowed an opportunity to earn a fair rate of return. This Commission has used the end-of-period original cost investment rate base for a number of years and it is supported by ample legal precedent. Attorney General Miller agrees in this case with use of end-of-period rate base and we quote from pages 4 and 5 of his brief:

> "Why then use end-of-period rate base which obviously produces a lower rate of return than the Company actually earned .... The answer is simple. Experience has shown that utilities in recent years have not earned the rate

of return authorized because of the lag in the return of (sic) earnings during the period between the time the money is invested and the time the earnings are received in addition to the fact that earnings may be eroded by investment in new and higher cost plant than the average imbedded cost of plant at the time the rates were made. End-of-period rate base is a rate making tool employed in an attempt to offset these factors and make the rates representative of the period in which they are in use. The same result may be achieved by a specific adjustment to the cost of service or rate of return, or by a combination of all of the above."

Three of the interveners contended that customers' deposits should be deducted from the rate base. We have never deducted customer deposits from the rate base since these funds like any investor-supplied funds are not interest free to the Company.

Three of the interveners contend that deferred taxes should be deducted

from the rate base. We do not agree with this contention. We believe these amounts should be included in the capital structure and assigned a zero cost.

Two of the interveners take exception to cash working capital allowance and drastically reduce it based on a lag study performed by Arlington County. The staff would allow intrastate cash working capital in the amount of $7,831,388 representing twenty days of operating expenses, exclusive of depreciation and amortization. This is the formula used by the Commission in all of its telephone rate cases. The Company, although using the same cash working capital as the staff, prepared a lead-lag study which shows a need for

cash working capital in the amount of $9,422,000. The staff reviewed this lag study and agreed with the procedures used in making the study without checking it in detail. It confirmed the Commission's experience from other proceedings that when a lag study is made by a company, cash working capital requirements are always comfortably in excess of those determined by applying our formula, which we will continue to apply in this case.

The Commission finds that the Virginia intrastate rate base of $805,860,163 as developed by the staff is proper; however, as indicated earlier new reduced depreciation rates have been approved, the effect of which must now be considered with respect to rate

base.

In order to explain the proposed adjustment, it should be remembered that depreciation rates are prescribed by the Federal Communications Commission.[6]

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[6]The Federal Communications Commission is required under the Federal Communications Act to prescribe the proper depreciation rates for the interstate companies. They have on their staff a group of experts headed by Mr. Robert G. Warnek who spend their full time on depreciation studies. They have scheduled a review of the rates of each Bell operating company every three years at which time new or changed rates are prescribed for the future. The test year, 1972, was the year for review of rates of the C&P Telephone Co. of Va.

The State Corporation Commission must approve the rates and depreciation charges allowed to be used for operating expenses for public utilities operating in Virginia. The Engineers and Accountants on its staff review the rates in effect and determine changes based on trends in the industry and their knowledge of changes in local conditions. They work with the FCC where there is joint responsibility.

The rates are normally reviewed and changed every three years. The depreciation rates of the C&P Telephone Company of Virginia were scheduled for revision in 1972. Extensive studies were made of past history, present conditions and future plans for each class of property by the C&P Telephone Company, the Federal Communications Commission and by this Commission. (Recently, the Federal Communications Commission prescribed rates which, on the whole, are lower than the rates in effect during the test period.) Near the conclusion of the hearing in this proceeding, several witnesses alluded to the possibility that the proposed new depreciation rates would result in a lowering of depreciation expense in the

range of $1,000,000 to $4,000,000. We cannot make accounting adjustments based on conjecture but must rely on facts. Now, the Federal Communications Commission has released its prescribed rates for 1972 and 1973 and the stated effect is to reduce Virginia intrastate depreciation expense by $2,617,464 in 1972 and $4,932,160 in 1973. At this point, then, we are concerned with the effect of the modification of C&P's depreciation rates on the rate base. Accordingly, an adjustment will be made reducing the depreciation reserve by $2,617,464 for the year 1972. We believe that this is the only necessary depreciation adjustment to the 1972 rate base. With this adjustment, the Virginia intrastate rate base would be

increased to $808,477,597 as reflected in the following table.

TABLE NO. 1

Virginia Intrastate Rate Base
as of December 31, 1972

Telephone Plant at December 31, 1972	
Telephone Plant in Service	$ 963,773,952
Telephone Plant under Construction	37,792,000
Property Held for Future Telephone Use	690,933
Total Telephone Plant	$1,002,256,885
Less: Depreciation Reserve	$ 206,029,063
Net Telephone Plant	$ 796,227,822
Allowance for Working Capital	
Materials and Supplies	$ 4,418,387
Cash (Approximately 20 Days of Operating Expenses, Exclusive of Depreciation and Amortization)	7,831,388
Total Allowance for Working Capital	$ 12,249,775
Net Utility Plant and Allowances	$ 808,477,597

Based on the foregoing, we conclude that no valid reason has been advanced why we should change our historic method of determining rate base, and, therefore, find that C&P's Virginia intrastate end-of-period rate base as of December 31, 1972, is $808,477,597.

Now it is appropriate to consider the Company's operating revenues and expenses during the test year.

Operating Revenues and Expenses

As previously indicated, C&P equipment is used for both intrastate and interstate communications. Since the books and records are maintained on a company-wide basis, there is no direct way to segregate C&P's intrastate book costs, reserves, operating expenses and revenues. Since this Commission has

jurisdiction over C&P's Virginia intrastate toll and exchange operations, it is necessary to follow some proper method for separating the factors applicable to C&P intrastate operations from its total operations. Also, as stated earlier, the standard procedures used for years by this Commission and other Commissions throughout the United States for separating telephone property costs, revenues, expenses, taxes, and reserves are set forth in the "separations Manual," published by the National Association of Regulatory Utility Commissioners and adopted by the Federal Communications Commission. These procedures have been applied by both the staff and the Company in determining C&P's Virginia intrastate

revenues and expenses.

Total operating revenues amounted to $412,463,747. Of this amount $310,199,882 was determined to be Virginia Intrastate Revenues. Certain pro forma adjustments were necessary to reflect the true conditions during the test period. These were: an adjustment of $697,117 increasing revenues resulting from a change in accounting procedures for Extended Area Service (EAS) settlements with independent companies; an adjustment of $229,493 decreasing revenues from EAS settlements with independent companies, which are applicable to prior years, based on 1972 cost study; elimination of $342,551 of additional revenue resulting from higher Pentagon rates

applicable to December, 1971, but not booked until September, 1972; reduction in toll revenues in the amount of $829,272 resulting from a change in toll settlement procedures (from average to cost basis) with independent companies; adjustment eliminating $138,764 of additional intrastate toll revenues which resulted from Hurricane Agnes; and, an adjustment of $1,711 reflecting the effect of these revenue adjustments on the uncollectible account. With these adjustments total intrastate revenues become $309,358,630.

The Company shows adjusted revenues in the amount of $309,496,000 or $137,370 in excess of the staff's figure. One major adjustment accounts

for slightly more than the difference. The staff eliminated $138,764 representing intrastate toll revenues resulting from Hurricane Agnes. Also, we made a small adjustment reducing the provision for uncollectibles as a result of our reductions in operating revenues, which increases revenues by $1,711.

Several interveners assert that various revenue adjustments should be made. The Virginia Committee for Fair Utility Rates takes the position that if 1973 wage increases are allowed, then some adjustment should be made for expected increases in revenues due to growth of telephones in service; the Attorney General takes the position that if existing rates were applied to

end-of-period telephones in service and annualized in the manner in which other adjustments are handled, the Company would have received about $19,900,000 in additional revenues bringing the adjusted revenues for rate-making purposes to $330,100,000; the Department of Defense contends that if we use the end-of-period rate base, then we must use revenue based on stations in service at the end of the period.

We disagree with the interveners that test-year revenues should be adjusted for growth. If revenues are adjusted for growth, then it is both logical and fair to make adjustments for increased expenses and growth in

investment. This would simply be a way of substituting a new test period for the one used. With our adjustments, C&P's adjusted Virginia intrastate revenues during the test period amounted to $309,358,630.

a. Operating Revenue Deductions

(1) Total Company and Intrastate

Operating revenue deductions consist of operating expenses, depreciation, and taxes other than Federal income taxes. For the Company, total operating revenue deductions amount to $334,685,381. Applying the factors developed in the Separations Study, we conclude that operating revenue deductions applicable to Virginia intrastate operations (including

$101,409 charitable contributions) amount to $248,610,456. No exception was taken by any intervener with regard to the determination of Virginia intrastate separations.

(2) Adjustments Proposed and Allowed

The staff's proposed adjustments to operating revenue deductions, prior to Federal income taxes, would result in an increase of $6,589,843. The Company's proposed adjustments would increase operating revenue deductions by $10,649,000.

Listed below is a comparison of the staff's and Company's proposed revenue deductions:

		SCC STAFF	COMPANY	DIFFERENCE (COMPANY OVER STAFF)
(1)	Wage adjustment	$4,434,641	$8,043,000	$3,608,359
(2)	Exp. - Hurricane Agnes	(332,968)	-	332,968
(3)	Savings thru Consolidation-Nansemond Office	(134,088)	-	134,088
(4)	Annual Savings in Equipment Rental	(64,631)	-	64,631
(5)	Rental Expense Applicable to Prior Period	(29,014)	-	29,014
(6)	Adjust Directory Expense to Amount Applicable to Test Period	38,444	-	(38,444)
(7)	Retroactive Settlement of Leased Microwave Facilities - Prior Period	(41,917)	-	41,917
(8)	Increase Expenses due to Credit Adjustment Applicable to Prior Period	39,765	-	(39,765)

		SCC STAFF	COMPANY	DIFFERENCE (COMPANY OVER STAFF)
(9)	Adjustment of Co. Fed. Inc. Tax Provision to computed amount	80,981	-	(80,981)
(10)	Gross Receipts Adjustment Due to Revenue Adjustments	(29,360)	(24,000)	5,360
(11)	5 Adjustments - Difference Due to Company Rounding to Nearest Thousands	2,627,990	2,630,000	2,010
				$4,059,157

b. Comments on Operating Revenue Deductions

As will be observed above, the staff allowed a wage adjustment of $4,434,641 while the Company made an adjustment of $8,043,000. The staff, following our recently adopted rate-making procedures, would sanction the projection of a future wage expense only to the extent of twelve months following the test period. The Company included in its pro forma wage package a wage adjustment in consequence of the cost-of-living index increasing from $5.00 to $8.00, per week, effective July 16, 1973. This cost-of-living adjustment increases operating expenses by $1,251,923 annually; however, to comply with our rate-making procedures only that part

of the cost-of-living adjustment paid during the period July 16, 1973, through December 31, 1973, which is within one year following the test year, can be allowed. This increases operating expenses by $573,381 and after allowing for the tax effect, would increase operating revenue deductions by $298,152.

It should be stated at this point that we recognize that rates are made for the future and that the $5,008,022 wage adjustment we have allowed is $3,034,978 less than that sought by the Company; still, under our rate-making procedures which are applicable to all regulated utilities, we can pro form expenses for twelve months beyond the test period only, which we have done.

Also, we realize that the rate relief herein granted will not be reflected in C&P's operations until early 1974; however, we will examine C&P's operations on annual review in early 1975 and take any action which might be appropriate at that time.

Governor Howell urges disallowance of Charitable contributions. Other interveners take exception to the Company's going level adjustment for the 1973 wage increases.

The staff has allowed net charitable contributions in the amount of $101,409. The allowance for such contributions has been approved by the Supreme Court of Virginia. In Arlington County Board of Supervisors v. Virginia Electric and Power Company,

196 Va. 1102, on page 1118, the Court approvingly quoted Commissioner Hooker as saying:

> "...it can not be overlooked that utilities are expected to make reasonable charitable donations, because a refusal might bring on the loss of the good will of the community it serves, while other businesses make donations for worthy causes. The amount allowed was only $76,876, which was not of any significance in determining the net income in this case."

Clearly, by present-day standards, reasonable charitable contributions are a legitimate cost of doing business, and are necessary if a utility is to maintain its standing and good will in the community it serves. C&P's charitable contributions will be allowed.

Depreciation expense was mentioned earlier in our discussion of rate base.

Without repeating what has already been said, one will recall that when the record was closed in this case, the Federal Communications Commission had not approved the modified depreciation rates then under study by the Company, the Federal Communications Commission and this Commission. Since the conclusion of the hearing, the FCC has prescribed new rates and it has been determined that if these rates had been in effect during the test year, depreciation expense applicable to Virginia intrastate operations would have been reduced by $2,617,464 and after computing the tax effect would result in a net reduction in operating revenue deductions of $1,361,081. Considering this adjustment, which will

increase C&P's net revenues, together with the other adjustments previously mentioned, we note that the net effect would be to reduce operating revenue deductions by $1,062,929, resulting in total adjusted operating revenue deductions of $250,507,906. More specifically, this is shown as follows:

TABLE NO. 2

Level of Earnings Under Existing Rates - 1972

Total Operating Revenues		$309,358,630
Total Operating Revenue Deductions	$251,570,835	
Plus: Cost of Living-Wage Adjustment Net	298,152	
Less: Net Depreciation Revision	1,361,081	250,507,906
Net Operating Income		$ 58,850,724
Plus: Interest during Construction		3,045,347
Less: Charitable Contributions (Net)		101,409
Net Operating Income Adjusted (Current Level of Earnings)		$ 61,794,662

The above demonstrates that the test period level of earnings was at a rate of 7.64% on a rate base of $808,477,597 as shown in Table 1 on page 82.

RATE OF RETURN

The Commission is presented with widely disparate proposals on the issue of rate of return.[7] C&P urges the Commission to approve a rate of return of not less than 9.33%, based upon AT&T's consolidated objective capital structure. Possibly, no issue raised in this proceeding prompted more discussion than the matter of what

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[7]The opinions of the cost-of-money experts testifying in this proceeding were as follows:

7 (Continued)

WITNESS	PARTY	OVERALL RATE	RETURN ON EQUITY
Dr. Olson	Dept. of Defense	7.9 - 8.3%	9.3 - 10.1%
Mr. Locanto	Attorney General	8.03 - 8.25%	10.2 - 10.7%
Mr. Hammond	Arlington Co.	8.13%	10.75%
Mr. Jones	VCFFUR	8.1 - 8.3%	9.77 - 10.19%
Dr. Ileo	Staff	8.29 - 8.68%	10.2 - 10.7%
Dr. Morton	C & P	9.33%	12.5%
Mr. Burns	C & P	9.25%	12.5%

capital structure should be used in determining a fair return for the Company. The interveners generally agreed on a debt ratio in the range of 50 to 55 percent. Dr. Ileo, a witness for the staff, and Dr. Jones, testifying for the Fair Rates Committee, both feel that a debt-equity ratio of 50% would be fair and reasonable.

Indisputably, cost of capital is essential to a proper determination of an overall rate of return. The following table shows C&P's capital structure and cost of capital as of December 31, 1972, together with its established cost of money, save for equity:

TABLE NO. 3

Total Cost of Capital
as of December 31, 1972

CAPITAL ITEM	AMOUNT OUTSTANDING	PERCENTAGE	COST	RETURN COMPONENT
Long-Term Debt	$ 360,973,572	34.62	6.81%	2.35%
Short-Term Debt	30,275,000	2.90	5.78	.17
Advances	21,700,000	2.08	6.00	.12
Common Equity	596,227,356	57.18		
1971 Job Development Credit	7,593,468	0.73		
Deferred Taxes	26,023,516	2.49	0	0
Cost of Capital	$1,042,792,912	100.00		

The above computations rest on costs predicated on the record. For the purpose of this proceeding, the capitalization ratio of C&P cannot be used since there is no reasonable relationship of C&P's capital structure to that of its parent, AT&T. It has been suggested that the parent's cost of capital be imputed to C&P. This has been the practice in past rate cases before this Commission. In City of Lynchburg v. Chesapeake and Potomac Telephone Company of Virginia, 200 Va. 706, which involved an appeal from a decision of this Commission granting C&P a rate increase, one of the issues decided by the Court was that it was proper for the Commission to use the

debt ratio of the parent Bell System of which the Virginia Company is a part. Specifically, the Court made the following pertinent observations on pages 719 and 720 of its opinion:

> "The majority of the Commission adopted the debt and equity ratios accepted by its staff and fixed the rate of return at 6.38%, which the staff found to be the actual earning experience of the Bell System in 1956. Commissioner Catterall thought the proper basis for calculating the rate of return should be a capital structure of 42% debt and 58% equity, which he used in calculating the required rate of return to be 5.83%.
>
> * * *
>
> "The appellants argue that the 'overwhelming weight of authority is that a debt ratio of 45% debt, 55% equity, is fair and reasonable to the public utility and to the consumer and financially sound and appropriate.'
>
> "It is unquestionably true that many of the State commissions have held that a debt ratio of 35% was too low to use as a basis

for establishing the rate of return allowed to telephone companies.

"The appellate courts of Louisiana, Massachusetts and Vermont have declined to interfere with such findings of their State commissions.

"Other commissions, however, have refused to substitute a hypothetical capital structure for the one established by company management in the absence of evidence which admits of little argument that such should be done.

"In the Norfolk case we said that 'as a practical matter the debt ratio must be reasonable and safe and the rate of return on the base such as to pay interest on the debt and afford reasonable assurance to investors that the utility under prudent management will be able to meet the economic obligation to pay reasonable dividends. Otherwise, its equity capital (stock) will not be attractive to investors and thus not readily salable.'

"Courts and commissions should of course take a long look at the record before deciding that a public utility should owe more money than it does. That question is primarily for the judgment and integrity of its management. It is only when it is made clear by the evidence that the officers and directors are following a policy in this regard which unreasonably favors the stockholders at the expense of the consumers that the rate-making tribunal should substitute a capital structure radically different from one fashioned by the officers and directors of the corporation. The evidence in this case does not warrant our overturning the Commission's action and substituting a different judgment." (footnotes omitted)

Likewise, the evidence in this case does not justify departure from use of the Bell System's capital ratio and we will, therefore, use AT&T's consolidated objective capital structure of 45 percent debt, 4 percent preferred and 51 percent equity, which capital

structure insofar as C&P is concerned is hypothetical. We feel that use of AT&T's consolidated objective capital structure for rate-making purposes is fair to both the subscribers and the Company.

The determination of a just and reasonable overall rate of return hinges upon whether such a return is sufficient to permit a company to attract capital and maintain its financial integrity. We recognize that return on equity alone is not decisive and cannot be determined by any precise formula, although it is an important factor for our consideration in determining an overall fair rate of return which the Company will be given an opportunity to earn. The determina-

tion of a proper rate of return is a matter of informed judgment based on the facts of each case. This approach to rate of return is clearly required by the applicable statutes and controlling precedents of both this Commission and the Supreme Court of Virginia, which require that the rates "be as low as possible, and yet sufficient to induce the investment of capital in the business and its continuance therein."

Taking into account the hypothetical capital structure developed above, we conclude that an overall rate of return of 8.65% is just and reasonable. This would afford the Company an opportunity to earn a return on equity of about 11 percent.

In using a hypothetical capital structure with a 45 percent debt ratio the effect of the increased interest expense will serve to reduce C&P's Federal income tax and thus increase net operating income. We estimate that the effect of the 45 percent debt ratio would result in decreasing Federal income taxes by $1,862,215 and increasing net operating income by a like amount. Therefore, net operating income adjusted for the year 1972 and further adjusted for the effect of the hypothetical capital structure would be as follows:

TABLE NO. 4

Level of Earnings Under Existing Rates - 1972

Total Operating Revenues		$309,358,630
Total Operating Revenue Deductions	$251,570,835	
Plus: Cost of Living Wage Adjustment	298,152	
Less: Net Depreciation Revision	1,361,081	
Less: Reduction in Federal Income Tax as result of Hypothetical Debt Ratio	1,862,215	248,645,691
Net Operating Income		$ 60,712,939
Plus: Interest During Construction		3,045,347
Less: Charitable Contributions (Net)		101,409
Net Operating Income Adjusted		$ 63,656,877

Applying the allowed return of 8.65% to the adjusted rate base of $808,477,597 we are able to determine C&P's earnings requirements, and by deducting the adjusted net operating income as reflected in Table 4 above we are able to determine the additional earnings required by the Company as follows:

December 31, 1972 Rate Base	$808,477,597
Percentage Rate of Return	8.65
Total Net Earnings Needed	$ 69,933,312
Net Earnings - Test Period (After Adjustments) -	63,656,877
Additional Net Earnings Needed	$ 6,276,435
Additional Gross Earnings Needed	$ 12,636,371

It is, therefore, concluded that the Company requires $12,636,371 in additional gross revenues. As stated earlier, C&P filed schedules designed

to provide additional gross revenues of $32,711,000, some $20,074,629 in excess of the additional revenues we feel are necessary to be borne by the public. We now turn to consideration of how to distribute equitably the increase authorized among C&P's various classes of customers.

RATE DESIGN

Essentially, rates must be designed to produce the necessary revenue, distribute the burden of meeting the revenue requirements fairly among the Company's customers and establish a reasonable relationship between the cost incurred and the benefits provided. For the most part the parties have not challenged C&P's rate structure, except for one or two objections to the

charges for end-use equipment and services. In determining how the approved increases should be distributed, we have followed the foregoing criteria. In order to ensure a balanced rate structure, we have determined the areas in which reductions should be made from the rates proposed in the tariff schedules under consideration, all of which changes will be supervised by this Commission.

Distribution of the additionally approved revenue is a difficult undertaking since telephone companies offer a variety of services for both residential and business customers, the rates for which are published in numerous tariff schedules. Consequently, instead of discussing individual rates in detail,

we will consider briefly the objectives and standards followed in distributing the revenue.

C&P's present rate tariffs were found to be just and reasonable by this Commission in the 1971 rate proceeding, Application of Chesapeake and Potomac Telephone Company, 91 PUR 3d 437. These rates are reasonably related and for some time have been relied upon by C&P's customers. While certain interveners in this proceeding seek substantial adjustments in a particular service to which they subscribe, we must consider the Company's entire rate structure.

Testimony was adduced concerning cost of service - particularly with respect to terminal equipment - by an

interconnect company which furnishes terminal equipment in competition with C&P. While competition is a basic postulate of the free enterprise system, it is in the public interest to allow certain regulated or controlled monopolies to operate under the aegis of state and federal regulatory agencies. In Parker v. Brown (1942), 317 U.S. 341, 87 L ed. 315, the United States Supreme Court observed that the Sherman Antitrust Act makes no mention of the state as such and "gives no hint that it was intended to restrain state action or official action directed by a state."[7] Even though the Federal Antitrust Acts are not applicable to state action, an

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[7]See 87 L. ed. at 326.

unregulated industry has a right to compete with a regulated industry for certain service and equipment offerings, a right which has been upheld in several decisions of the Federal Communications Commission, the most notable being the Carterfone case, supra. Obviously, if a utility were disposed to do so, and if the regulating agency acquiesced, the utility could price its terminal equipment so as to make it impossible for interconnect companies to compete and survive. We are fully cognizant of this fact and will establish competitive rates for interconnect services. But in doing so, this Commission cannot and will not guarantee the survival of interconnect companies operating in Virginia to the detriment of the general

public. To do so would eliminate the competitive factor in telephone rate making for which the interconnect company is here contending.

Accordingly, rates approved for interconnect services must afford such companies an opportunity to compete in supplying telephone end-use equipment so long as such rates bear a reasonable relationship to the cost to the regulated utility.

Much of the evidence and argument of record involving rate design concerned two pricing concepts, "cost of service" and "value of service." Certain witnesses advocated utilization of cost of service as a rate-making tool to the total exclusion of value of service; however, we are satisfied that

both concepts are appropriate to the telephone rate-making process and must be used in an appropriate balance, depending upon the conditions developed in each rate proceeding.

The current trend in telephone rate making is to place greater emphasis on cost of service. There are several reasons for this. First, those who engage in above-average utilization of telephone service contribute relatively more to the need for larger plant investments by the companies and should bear a proportional share of such increased cost. Second, in recognition of the emergence of the interconnect industry, regulatory agencies should be conscious of and give proper weight to the cost of terminal equipment. In the

instant case, C&P manifests a desire to follow the trend and structure its rates more closely to the cost of providing service, placing less significance on value of service. In this regard, testimony was adduced with respect to the usage, residential and business classifications, cost of terminal equipment, cost of installation, and miscellaneous and supplemental services. We agree with this approach.

Although the value of service and cost of service standards are identifiable choices for rate-making purposes, there is a parallel relationship between these standards. To illustrate, when a higher rate is established for a group of residential customers able to call more people over a wider area than

customer groups charged lower rates, the Company's cost of serving the higher rated group is generally more than the cost incurred in serving the lower-rated groups. Similarly, rates for business telephones should be higher than those charged for residential telephones, since on a call-for-call basis, the value of service is greater for business than residential customers, plus the fact that significantly larger plant and personnel costs are incurred in providing business service. Of course, no more should be exacted from the public for a service rendered than such service is reasonably worth. In determining the worth of a given service, we must, to the extent possible, consider both cost and value.

Even if we were disposed to establish rates on a cost-of-service basis, it is not possible to do so under present accounting procedures. The practical problems associated with determining the cost of plant and the expenses of operation and maintenance for a given residential or business group of customers are numerous and complicated. Hopefully, in the future the telephone industry, in cooperation with the regulatory bodies and the National Association of Regulatory Utility Commissioners, will develop both the cost-finding techniques and equipment necessary to measure accurately costs on the basis of the number of calls made, distance of a particular call, length of conversation, type of

equipment used, etc. When this is accomplished, we will be in a better position to reevaluate the balance between cost and value of service in telephone rate making.

We have reviewed C&P tariff schedules to determine which of the present rates should be increased to produce $12,636,000 of additional revenue. The Company proposes to increase the rates for basic monthly exchange service for residential and business customers to realize additional revenues in the amount of $14,405,000. This would increase business customers' rates by $5,998,000 and those of residential customers by $8,407,000. The increase to residential and commercial customers should be reduced to $3,539,000, allo-

cated to increase residential service by $1,681,000 and business service by $1,858,000.

It appears that under the proposed rates there will be an unreasonable disparity between interstate and intrastate message toll calls for comparable distances. The proposed rates would result in additional annual gross revenues of $2,989,000. Rates to produce additional annual gross revenues of $1,823,000 from message toll service will be approved.

It is evident to us that the rates assessed for service connections, etc., are not compensatory and should be increased. However, we must consider the limited ability of some subscribers to bear the cost of obtaining essential

telephone service. We find that increasing the revenue from these services approximately one-half the amount proposed by the Company would be more equitable to the general public at this time. The increase in revenue from service charges should be reduced from $5,874,000 to $2,330,000.

Evidence was introduced regarding the cost of providing equipment for PBX and Centrex services. The rates for both of these services should be increased, subject to two primary considerations. First, the increases should be moderate so that the impact upon existing customers will be reasonable. Second, PBX and Centrex services are primarily for those customers who have need for a large number

of telephone stations. A single service-offering providing multiple communication stations must have a reasonable and proper relationship to the rates for a service-offering of one communication station. The rates proposed by the Company to produce additional annual gross revenues of $1,959,000 from PBX service should be re-designed to produce $1,295,000, and those proposed for Centrex services in the sum of $2,511,000 should be re-designed to produce $1,296,000.

Rates for dedicated line services (e.g. burglar alarm services, etc.) were increased substantially two years ago. Further increases now to dedicated line subscribers would have an unreasonable impact on those affected and the

proposed increases are therefore denied.

The tariff provided for telephone answering service as introduced by C&P Witness Kelly is reasonable except that mileage charges will not be increased for the reason stated above concerning denial of dedicated line increases.

The proposed monthly rate increases for connections with customer provided systems, equipment and facilities, are denied. Finally, the proposal to increase coin service on pay telephones from 10 to 20 cents is also denied.

The balance of the increase approved will be distributed among other rate classifications as proposed by the Company except for our changes as they affect rates for miscellaneous and

supplemental equipment, which will be reduced by approximately $20,000.

CONCLUSION

The Company's 1972 test-year level of earnings was at a rate of 7.64 percent on a rate base of $808,477,597. It is, therefore, obvious that revenue relief is necessary. In resolving the important question of how much additional revenue C&P requires, we have concluded that, based on a 1972 test-year rate base of $808,477,597, an overall rate of return of 8.65 percent, and the projected revenues extended for one year beyond the test period, C&P has need for an additional $12,636,371 in gross revenue. The amount of the increase authorized should be distributed among the various service classifications

in accordance with this opinion. We will review the Company's operations and examine its revenues on annual review in early 1975 after the Company has had one year's experience under the rates herein approved.

HARWOOD, Commissioner, concurs.

CHAIRMAN BRADSHAW concurs with the majority except as hereinafter noted:

I agree with the majority except in those instances in which the determination of a rate base conflicts with the objections set forth in my opinion of November 30, 1973, in Case No. 19218, Application of Commonwealth Gas Distribution Corporation For a revision of its rates and charges, rules and regulations. One reduction to the rate base, among others, I advocated in that

case was due to the deposits received from subscribers and held as security for payment of bills.

At the end of the test period, C&P held more than $2,000,000 in this deposit account upon which it pays 6 percent interest to its subscribers. Again, I would recognize this money as a source of low cost funds to the Company and reduce the rate base in the same manner as in the case cited above, thereby disallowing a return to the Company on customer monies.

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IN THE
SUPREME COURT OF VIRGINIA
At Richmond

No. 740406

Henry E. Howell, Jr., :
Appellant,
:
v.
:
The Chesapeake And Potomac Telephone
Company of Virginia :
and
:
State Corporation Commission,
Appellees. :

IN THE
STATE CORPORATION COMMISSION
OF VIRGINIA

No.19152

In re :

Application of THE CHESAPEAKE AND :
POTOMAC TELEPHONE COMPANY OF VIRGINIA
for an increase in rates. :

NOTICE OF APPEAL TO THE
SUPREME COURT OF THE
UNITED STATES

I.

Notice is hereby given that Henry E.

Howell, Jr., the appellant above named, hereby appeals to the Supreme Court of the United States from the final judgment of the Supreme Court of Virginia entered March 10, 1975, denying appellant's petition for rehearing of the opinion of the Supreme Court of Virginia entered January 20, 1975, affirming the legislative action of the Virginia State Corporation Commission of January 9, 1974, in allowing The Chesapeake and Potomac Telephone Company of Virginia a $12,636,371.00 annual increase in intrastate telephone rates in violation of the rights guaranteed to appellant under the Fifth and Fourteenth Amendments to the Constitution of the United States.

II.

This appeal is taken pursuant to

28 U.S.C. §1257 (2).

III.

This appeal is limited to the question of the constitutionality of the legislative action of the State Corporation Commission of Virginia in including customer contributed funds in the rate base and computing rate of return on nonjurisdictional business.

IV.

A copy of this Notice Of Appeal is being filed with the Clerk of the Supreme Court of Virginia, which Court entered the final judgment appealed from, and a copy is being filed with the Clerk of the State Corporation Commission of Virginia, which Clerk now

possesses the Record.

s/ Henry E. Howell, Jr.
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Counsel for Appellant

PROOF OF SERVICE

I, Henry E. Howell, Jr., an attorney duly qualified before the Supreme Court of the United States and representing myself as appellant herein, hereby certify that on the 21st day of May, 1975, I served copies of the foregoing Notice Of Appeal to the Supreme Court of the United States on the several parties thereto, as follows:

1. On The Chesapeake and Potomac Telephone Company of Virginia, by depositing a copy in a United States Mail Box in a duly addressed envelope, with first class postage prepaid, to Joseph E. Blackburn, Esquire, c/o The Chesapeake and Potomac Telephone Companies, 1710 H Street, N.W., Washington, D.C. 20006, its counsel of record in the proceedings before the Supreme Court of Virginia and the State Corporation Commission of Virginia, and by depositing a copy in a United States Mail Box in a duly addressed envelope, with first class postage prepaid, to A. W. Whittaker, Esquire, c/o The Chesapeake and Potomac Telephone Company of Virginia, 703 E. Grace Street, Richmond, Virginia 23219.

2. On The State Corporation Commission of Virginia, by depositing a copy in a United States Mail Box, in a duly addressed envelope, with first class postage prepaid, to Richard D. Rogers, Jr., Esquire, c/o State Corporation Commission, Blanton Building, Richmond, Virginia 23219, its counsel of record in the proceedings before the Supreme Court of Virginia and the State Corporation Commission of Virginia, and by depositing a copy in a United States Mail Box in a duly addressed envelope, with first class postage prepaid, to Honorable Andrew P. Miller, Attorney General of Virginia, Supreme Court Building, Richmond, Virginia, 23219.

s/ Henry E. Howell, Jr.
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